Sandra Steindl

Turbulence in Financial Markets, Economic Growth in Austria Remaining Robust

Business Cycle Report of September 2007

The US housing crisis has triggered turbulence in financial markets. In Austria, economic growth has maintained its momentum. In the second quarter, real GDP expanded by 0.9 percent (seasonally and working day adjusted) from the previous period. The main drivers of growth were once again manufacturing and external trade. In the euro area, leading indicators point to ongoing robust expansion, despite the moderation of growth in the second quarter.

All staff members of the Austrian Institute of Economic Research contribute to the Business Cycle Report. • Cut-off date: 6 September 2007. • E-mail address: Sandra.Steindl@wifo.ac.at

The Austrian economy grew at a quarterly rate of 0.9 percent in real terms (seasonally and working day adjusted) in the second quarter of 2007, according to the revised figures (following a growth of also 0.9 percent in the first quarter). On a year-on-year basis, the growth rate was 3.5 percent.

Ongoing strong industrial activity and the export sector continue to provide significant stimulus to growth: goods exports rose by 0.9 percent from the previous quarter, imports increased by 0.6 percent. The international environment is favourable to external trade. After a modest start early in the year, the US economy regained momentum in the second quarter, with notably investment picking up speed. The fragile housing market continues to pose a risk to both the USA and Europe, however. Leading indicators point to ongoing robust expansion in Europe, despite the moderation of growth in the second quarter and the turbulence in financial markets.

Economic activity remains buoyant also in Austria in the second half of the year, as the results of the WIFO business cycle survey of August show. Still excellent levels of domestic and foreign orders provide strong stimulus. Industry continues to expand at a robust pace, although growth in this sector seems to be already past its peak. In the second quarter, real value added by the manufacturing sector rose by 1.5 percent from the previous period (following +2.1 percent in the first quarter). The construction sector also saw the growth rate (second quarter +0.6 percent, compared with the previous period) remain below the high level at the beginning of the year attributable to the mild winter (first quarter +0.9 percent). Value added in the real estate, renting and business activities expanded more strongly than at the beginning of the year.

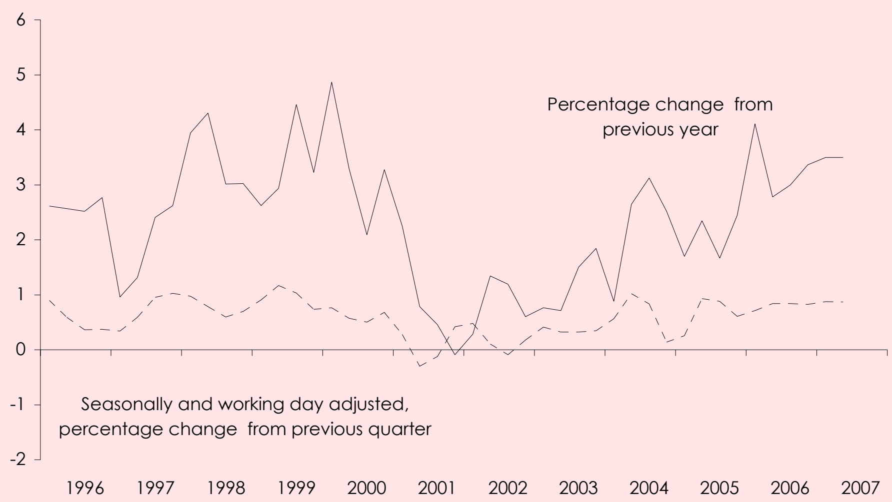
Capacity utilisation in manufacturing rose to 85.3 percent in July, a new record high. The demand for expansion investment (machinery and electrical equipment) remained high in the second quarter, reflecting capacity bottlenecks and healthy corporate profits. Given the decline in the demand for vehicle investment, total business spending on machinery and equipment, at +0.8 percent in the second quarter rose only modestly from the previous quarter. Construction investment developed favourably (+1 percent compared with the previous period), particularly in the non-residential sector.

Table 1: Quarterly national accounts

			2006				2007	
			First quarter	Second quarter	Third quarter	Fourth quarter	First quarter	Second quarter
			Percentage changes from previous quarter					
Adjusted for seasonal and working day effects, volume								
Final consumption expenditure			+ 0.5	+ 0.4	+ 0.4	+ 0.3	+ 0.3	+ 0.4
Households[1]			+ 0.5	+ 0.4	+ 0.4	+ 0.4	+ 0.3	+ 0.4
General government			+ 0.6	+ 0.5	+ 0.4	+ 0.3	+ 0.1	+ 0.2
Gross capital formation			+ 0.6	+ 0.9	+ 1.1	+ 1.1	+ 1.1	+ 0.7
Gross fixed capital formation			+ 0.4	+ 1.1	+ 1.5	+ 1.5	+ 1.4	+ 0.9
Machinery and equipment			+ 0.5	+ 0.2	+ 0.1	+ 1.0	+ 0.9	+ 0.8
Construction			+ 1.2	+ 1.8	+ 2.1	+ 1.9	+ 1.3	+ 1.0
Exports, goods and services			+ 1.6	+ 1.7	+ 2.0	+ 2.1	+ 1.6	+ 1.3
Goods			+ 2.7	+ 0.5	+ 2.0	+ 2.4	+ 1.5	+ 0.9
Services			+ 1.5	+ 1.6	+ 1.7	+ 1.6	+ 1.6	+ 1.6
Imports, goods and services			+ 0.9	+ 1.3	+ 1.6	+ 1.5	+ 0.9	+ 0.5
Goods			+ 1.4	+ 1.4	+ 1.4	+ 1.6	+ 1.5	+ 0.6
Services			+ 1.3	+ 1.7	+ 1.6	+ 0.9	+ 0.2	+ 0.3
Gross domestic product			+ 0.7	+ 0.8	+ 0.8	+ 0.8	+ 0.9	+ 0.9
Manufacturing			+ 2.4	+ 2.0	+ 2.0	+ 2.5	+ 2.1	+ 1.5
	2005	2006	2006				2007	
			First quarter	Second quarter	Third quarter	Fourth quarter	First quarter	Second quarter
			Percentage changes from previous year					
Volume, chained prices								
Final consumption expenditure	+ 2.0	+ 2.1	+ 2.1	+ 2.4	+ 1.9	+ 1.9	+ 1.1	+ 1.5
Households[1]	+ 2.0	+ 2.1	+ 2.2	+ 2.5	+ 1.7	+ 1.9	+ 1.1	+ 1.6
General government	+ 1.9	+ 2.1	+ 2.0	+ 2.1	+ 2.4	+ 2.0	+ 1.0	+ 1.1
Gross capital formation	– 1.3	+ 3.7	+ 7.8	+ 1.9	+ 4.6	+ 1.4	+ 12.2	+ 3.4
Gross fixed capital formation	+ 0.3	+ 3.8	+ 6.8	+ 1.0	+ 4.4	+ 3.8	+ 9.6	+ 5.5
Machinery and equipment	+ 1.0	+ 1.5	+ 6.9	+ 2.5	+ 1.6	– 4.1	+ 7.5	+ 3.8
Construction	+ 0.1	+ 5.1	+ 7.0	+ 0.1	+ 6.0	+ 7.8	+ 12.6	+ 6.4
Exports, goods and services	+ 6.2	+ 7.5	+ 9.7	+ 6.0	+ 5.8	+ 8.4	+ 7.9	+ 6.8
Goods	+ 6.3	+ 7.9	+ 11.9	+ 4.8	+ 6.6	+ 8.6	+ 9.1	+ 5.9
Services	+ 6.2	+ 6.4	+ 4.6	+ 9.6	+ 3.7	+ 8.1	+ 4.8	+ 9.5
Imports, goods and services	+ 5.0	+ 5.6	+ 8.6	+ 4.1	+ 4.6	+ 5.6	+ 8.0	+ 3.2
Goods	+ 5.7	+ 5.5	+ 9.6	+ 3.9	+ 4.8	+ 4.1	+ 9.2	+ 3.5
Services	+ 2.6	+ 6.1	+ 4.6	+ 4.7	+ 3.9	+ 10.9	+ 2.5	+ 1.6
Gross domestic product	+ 2.0	+ 3.3	+ 4.1	+ 2.8	+ 3.0	+ 3.4	+ 3.5	+ 3.5
Manufacturing	+ 3.2	+ 8.8	+ 11.8	+ 6.1	+ 7.8	+ 10.0	+ 8.7	+ 8.4
Gross domestic product, value	*+ 3.9*	*+ 5.1*	*+ 5.3*	*+ 4.9*	*+ 4.9*	*+ 5.3*	*+ 6.1*	*+ 6.1*

Source: WIFO. – [1] Including private non-profit institutions serving households.

Figure 1: Growth of real GDP



Source: WIFO.

Private consumption growth continues to be modest (+0.4 percent quarter-on-quarter, +1.6 percent in real terms year-on-year). While business in the retail sector was relatively good on average in the first six months of the year, motor vehicle sales remained sluggish. According to the WIFO business cycle survey of August, consumers expect cyclical developments to remain favourable and labour market conditions to ease further in the next 12 months, but do not anticipate a marked improvement in their personal financial position as a result. At the same time private households' inflation expectations for the next twelve months have reached as high a level as last recorded in summer 2001 before the introduction of euro notes. In recent months inflation was pushed higher notably by increases in energy and food prices, and in July rose to a rate of 2.1 percent.

The persistently favourable cyclical conditions were once more reflected in employment gains (August +51,300 from a year earlier). The unemployment rate was 5.3 percent in August, according to the Austrian method of calculation, a decline by 0.3 percentage point from a year earlier, or 4.3 percent (seasonally adjusted), according to the Eurostat calculation.

Mortgage crisis sparks financial market turmoil

US economic growth accelerated in the second quarter. The mortgage crisis sparked turmoil in financial markets.

US real GDP growth accelerated from just +0.2 percent in the first quarter of 2007 to +1 percent (seasonally adjusted) quarter-on-quarter in the second quarter. A positive contribution came from net exports and business spending on machinery and equipment. Following a weak start early in the year, industrial production expanded, and capacity utilisation rose to 81.9 percent in July, suggesting a pickup in investment activity. Household spending (accounting for around 70 percent of GDP) no longer rose as vigorously as in the first quarter. This is reflected also in the unexpected decline in imports.

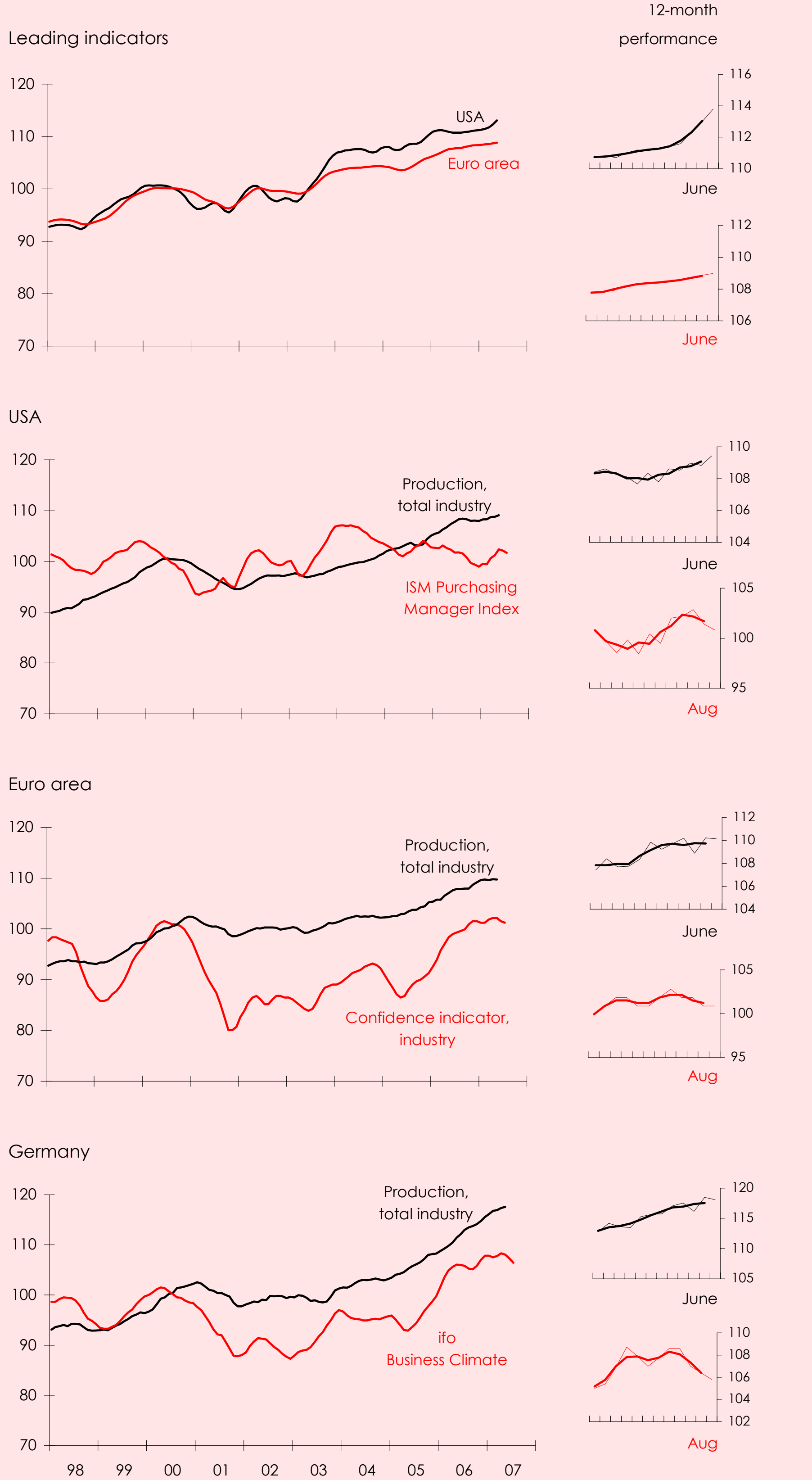
A correction of the overheated housing market has been under way since the beginning of the year. This year could see prices drop for the first time in years, with private consumption consequently receiving just little stimulus from this side. Concurrently, the decline in residential construction investment has accelerated considerably in recent months.

The continuous interest rate increases, coupled with the simultaneous decline in real estate prices sparked losses in the mortgage market, which subsequently also weighed on the bond and stock markets. At the beginning of August, stock prices tumbled. Central banks granted temporary credits to commercial banks to provide financial markets with liquidity and to prevent a surge in short-term interest rates. The US central bank also reacted to the financial market turbulence and unexpectedly lowered the discount rate by ½ percentage point to 5.75 percent. This was the first time since the turmoil following in the wake of the terrorist attacks of 11 September 2001 that the Fed intervened between two regular meetings. The federal funds rate was left unchanged at 5.25 percent. This step acted as a clear signal, stock markets recovered. The repercussions on the real economy are difficult to judge at this juncture; particularly the slowdown in real estate appreciation may dampen private consumption. Similarly, restraint exercised by banks in granting credit may stifle the pickup in investment in the USA.

Private households are also reacting to the economic slowdown and labour market conditions. Consumer confidence fell slightly in August, according to the Conference Board Consumer Confidence Index and the Reuters/University of Michigan Surveys of Consumers Index, which as important cyclical barometers indicate consumer buying behaviour in advance. Deteriorated labour market conditions are also weighing on consumer confidence. The number of claims for unemployment insurance – an unemployment indicator – rose in August. The seasonally adjusted unemployment rate increased from 4.5 percent in June to 4.7 percent in July.

Figure 2: International business climate

Seasonally adjusted, 2000 = 100, 3-month moving average



Source: European Commission, Deutsche Bundesbank, ISM (Institute for Supply Management™), ifo (Institute for Economic Research, Munich), OECD.

In Asia, economic activity has continued to expand at a solid pace. Ongoing rapid expansion in China and India has been contributing substantially to world economic growth. China's trade surplus continued to grow vigorously in the first half of the year, thanks to the particularly successful export sector. To stabilise inflation expectations in the wake of the country's rapid economic growth, China's central bank reacted with yet another increase in its key interest rate. In Taiwan too, the export boom in the first half of the year was reflected in dynamic expansion.

Japan's economy appears to have overcome its crisis, despite weak industrial output and modest GDP growth in the second quarter (+0.1 percent quarter-on-quarter). The demand for investment is rising, helped by corporate profits and export gains. Personal consumer expenditures are growing moderately. Japan's central bank has left the key interest rate unchanged at 0.5 percent since February 2007.

Growth slowing unexpectedly

In the second quarter, the upturn in the euro area slowed down markedly, with real GDP growth declining to a quarter-on-quarter rate of +0.3 percent, seasonally adjusted, in the second quarter from +0.7 percent in the first quarter. This slowdown was experienced by almost all large economies. Economic growth was particularly weak in Italy (+0.1 percent quarter-on-quarter), whereas growth decelerated only moderately in Spain (+0.9 percent, following +1 percent in the first quarter). In the EU 27, the seasonally adjusted quarterly growth rate was 0.5 percent in real terms (after +0.7 percent in the first quarter). The effects of Hungary's restrictive budget policy also dampened the average.

Growth in the euro area decelerated unexpectedly in the second quarter. However, leading indicators point to ongoing robust expansion.

While external trade remains the main driver of growth in Europe, private consumption has also gained momentum. The slowdown in the second quarter is reflected in a stagnation of industrial production; this suggests a run-down of inventories.

The assessment of the economic outlook for the euro area for the current quarter is nevertheless uniformly positive, despite this development in the second quarter and the US housing crisis. Order book levels in industry appear secured also for the time to come. The rise in August in the European Commission's Business Climate Indicator points to robust economic activity in the second half of 2007. The Consumer Confidence Indicator, while falling slightly in August, still stands above its long-term average, a sign of consumer confidence in both the euro area and the EU at large. The decline in unemployment that began with the upturn has shifted into slower gear in recent months. The seasonally adjusted unemployment rate for the euro area was 6.9 percent in July 2007, unchanged from June. The lowest rates were observed in Denmark (3.2 percent), the Netherlands (3.4 percent), Cyprus (4.1 percent) and Austria (4.3 percent).

Upturn decelerating in Germany

In Germany, the upturn unexpectedly lost momentum in the second quarter despite the continuing export boom. Real GDP rose by 0.3 percent in volume (seasonally adjusted) from the first quarter. Net exports were once more the drivers of growth (contributing +0.8 percentage point to seasonally adjusted GDP growth). But a positive stimulus was provided also on the domestic front. The marked increase in business spending on machinery and equipment (+2.5 percent) reflects healthy corporate profits. Following the VAT increase at the beginning of the year, private consumption recovered slowly in the second quarter, expanding by 0.6 percent from the previous quarter.

The German economy lost momentum in the second quarter. Private consumption rebounded, following the dampening effects from the VAT increase at the beginning of the year.

Value added generated by the construction sector declined (–5.2 percent). However, this must also be regarded as a counter-reaction to the vigorous growth due to the mild winter at the beginning of the year. In June, the main construction industry (firms employing a staff of 20 or more) recorded a fall in new orders by 2.4 percent in volume compared with the previous month. Construction investment also posted a marked decline (–4.8 percent).

The recent turmoil in financial markets is likely to have somewhat dented optimism regarding the economic outlook. The Ifo Business Climate Index cooled a little in August, but the majority of firms continue to view their business situation as very favourable. The index is still clearly above its long-term average, an indication of ongoing robust economic activity. The ZEW index also dropped in August. Being based on the views of financial market experts and institutional investors, however, it provides little information about the real economy.

With government revenues increasing strongly in the first half of the year, owing to both buoyant economic activity and the VAT increase, Germany recorded a government surplus. The labour market is also benefiting from the lively economy. In August, the unemployment rate dropped to 8.8 percent from more than 10 percent a year earlier.

Austria: solid expansion continues

The Austrian economy grew at a seasonally and working day adjusted quarterly rate of 0.9 percent in real terms in the second quarter (first quarter also +0.9 percent), according to the revised figures. Exports and industrial activity remain dynamic, with stimulus being provided by persistently high levels of domestic and foreign orders. At +1.5 percent, real value added growth in manufacturing was somewhat weaker than in the first quarter (+2.1 percent). The working day adjusted index of industrial production also rose at a slower pace; in the second quarter, it advanced by around 6 percent from where it had stood a year earlier – at the end of 2006, the beginning of the upswing, the growth rate had still reached around 10 percent. Growth in the manufacturing sector thus seems to be already past its peak. In construction, too, the high growth rates seen at the beginning of the year owing to the mild weather (first quarter +0.9 percent in real terms quarter-on-quarter) were no longer achieved in the second quarter (second quarter +0.6 percent in real terms).

In the second quarter of 2007, the Austrian economy grew at a seasonally and working day adjusted rate of 0.9 percent in real terms from the previous period. Export demand increased.

The assessment of order books in manufacturing and construction in the monthly WIFO business cycle survey also suggests a slowdown in economic activity: The share of manufacturers reporting sufficiently filled or more than sufficiently filled order books hit an all-time high of 85 percent in March 2007, and since then declined to the still very high reading of 81 percent. The assessment of order books in construction also deteriorated slightly, with the share of companies saying that order levels were too low rising from 15 percent in August 2006 to 23 percent this year. This is still 10 percentage points below the average over the past ten years.

Investment growth was subdued in the second quarter, despite well-filled order books. With the demand for vehicle investment declining, business spending on machinery and equipment in the second quarter advanced by only 0.8 percent from the previous quarter. Growth in construction investment was only marginally lower than of late (+1 percent quarter-on-quarter), with notably investment in non-residential construction rising vigorously since the second half of 2006.

With growth decelerating in Europe, foreign demand has lost some momentum. Goods exports according to the national accounts statistics remain an important pillar of economic activity (+5.9 percent in volume year-on-year, after +9.1 percent in the first quarter). Goods imports exceeded the year-earlier level by 3.5 percent in volume.

More than 70 percent of Austrian exports go to the EU 27, around 30 percent go to Germany. Overall exports to the EU 27 rose by 10.5 percent (cumulated) in the first half of the year, according to Austria's Foreign Trade Statistics. Exports to third countries, at +9.7 percent, also developed favourably.

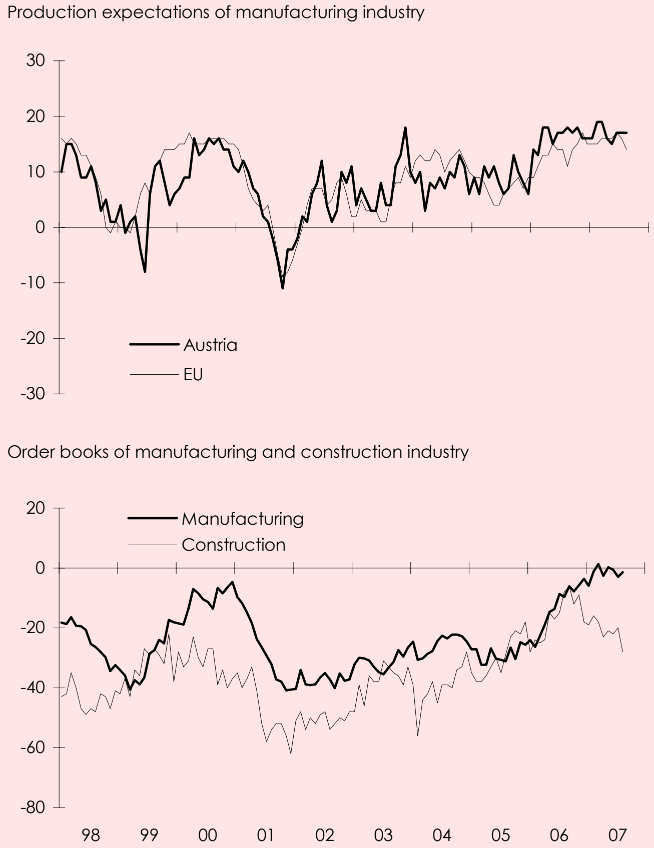
Private consumption still lacklustre

Business in trade was modest, with value added growth of 0.4 percent in real terms quarter-on-quarter. In retail trade, where sales volumes have been improving continuously since the first half of 2005, value added generated in the second quarter of 2007 exceeded the year-earlier level by 1.8 percent in real terms. In contrast, wholesalers reported business to have been slow; car sales declined in the first half of the year.

With household disposable income growing only slowly, private consumption remained lacklustre also in the second quarter, with no signs of a pickup yet in sight (+0.4 percent quarter-on-quarter, or +1.6 percent year-on-year).

Figure 3: WIFO business cycle survey

Differences between the percentage shares of correspondents giving positive and negative replies, seasonally adjusted



Source: European Commission, WIFO business cycle survey.

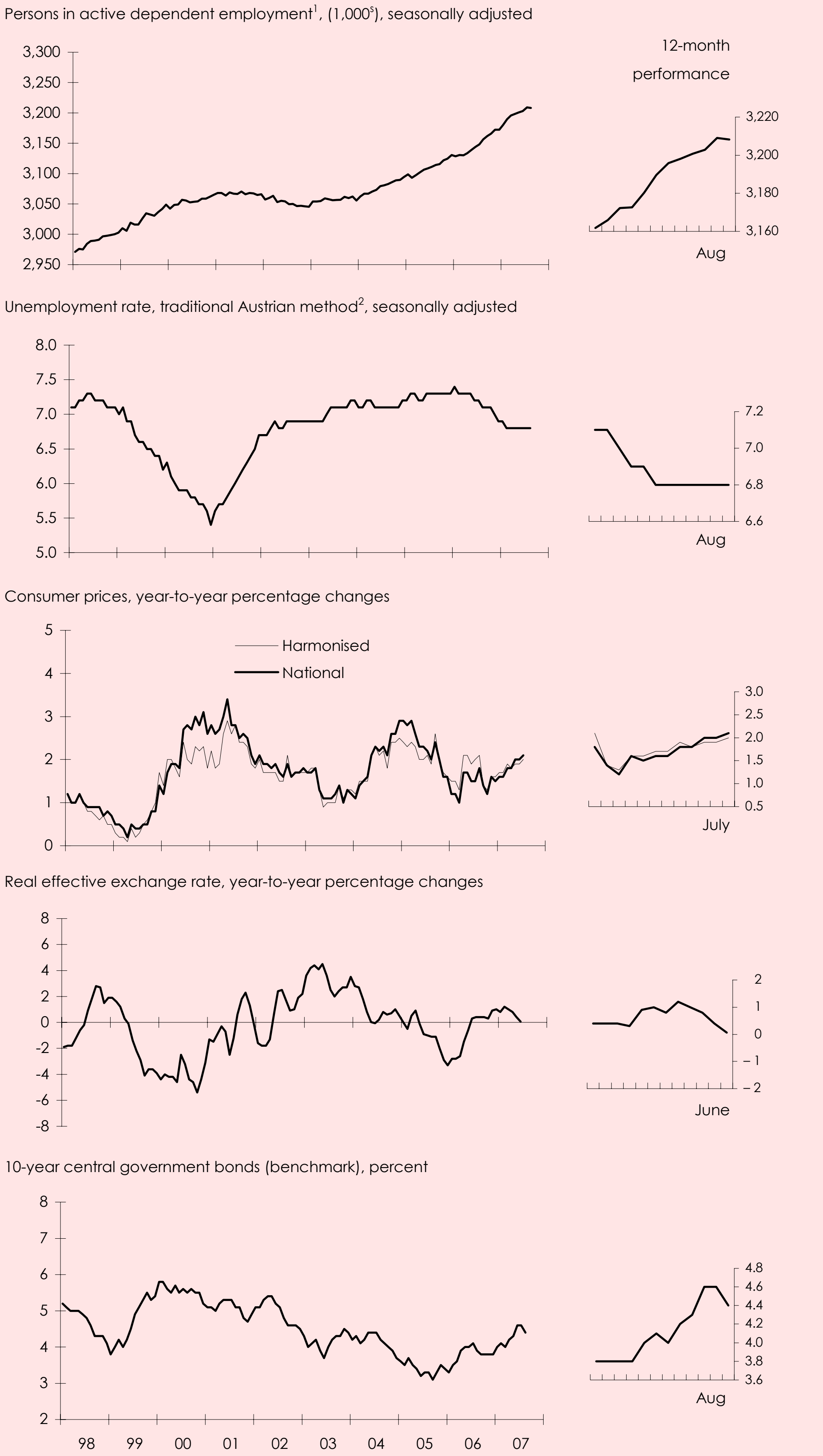
Looking ahead, private households do not anticipate a major improvement in their financial situation, but expect inflation to rise over the next twelve months. Consumers showed more confidence in August particularly regarding the general economic situation and a further improvement in labour market conditions.

Higher sales in summer tourism

In the first half of the 2007 summer season (May to July), tourism sales reached € 5.45 billion (+6.7 percent compared with a year earlier), according to preliminary calculations. The number of overnight stays by both domestic and foreign guests increased strongly (+4.6 percent in each case). Looking at the markets of origin, the picture is quite diverse: While vigorous gains were recorded for the demand from the Netherlands (+9.7 percent), Belgium (+7.6 percent), Switzerland (+7 percent), and Germany (+4.3 percent), the number of overnight stays plunged for travellers from France (–4.9 percent), the USA (–2.9 percent) and Italy (–1.4 percent). The British market recorded a slight increase from the year-earlier level (+0.6 percent).

Tourism sales rose in all federal provinces in the first half of the summer season. Developments were particularly successful in Vorarlberg, Carinthia and Tyrol. In the other federal provinces, the result remained below the Austrian average, and was weakest in Upper Austria and Vienna – albeit after an exceptionally high increase last year in Vienna.

Figure 4: Key economic indicators



Source: Public Employment Service Austria, Federation of Austrian Social Security Institutions, Oesterreichische Nationalbank, Statistics Austria, WIFO calculations. – [1] Excluding parental leave, military service, and unemployed persons in training. – [2] As a percentage of total labour force excluding self employed, according to Public Employment Service.

Inflation accelerating

Headline inflation rose to 2.1 percent in July, according to the calculations by Statistics Austria, and was thus higher than in the previous months (June and May 2.0 percent, April 1.8 percent). The expenditure group "housing, water and energy" continued to contribute around half to annual inflation. Food and non-alcoholic beverages were noticeably more expensive than early in the year, with this group currently accounting for somewhat more than one fifth of annual inflation. Prices declined once more in the main group "communications".

Inflation rose to 2.1 percent in July. The increase was largely attributable to higher prices for energy and food.

HICP inflation, at +2.0 percent month-on-month, also showed a slight acceleration of the upward drift in prices compared with the previous month (June and May 1.9 percent, April 1.8 percent). In July it exceeded the euro area average (1.8 percent). The lowest inflation rate in the EU was recorded for Malta (–0.2 percent), followed by Denmark (1.1 percent), France and Slovakia (both 1.2 percent), whereas the highest rate was once more registered by Latvia (9.5 percent), followed by Hungary (8.3 percent) and Bulgaria (6.8 percent).

Due to lively activity in manufacturing, industrial producer prices in Austria rose at an annual rate of 3.1 percent in the first half of the year, clearly faster than on average in 2006 (1.8 percent). Domestic market prices rose more strongly on average (+4.3 percent) than those for the export market (+1.6 percent).

After price rises in recent months, oil prices stabilised again in August, with one barrel of Brent crude listed at $ 71.3. Measured by the HWWI Index of World Market Prices of Commodities, commodity prices (expressed in euros) were approximately 2 percent lower in July than a year before.

Unemployment falling further

The buoyant economy continues to have a positive effect on the labour market. The number of persons in active dependent employment rose by 51,300 (+1.6 percent) in August, with employment gains widespread across sectors of the economy. The majority of newly created jobs are full-time jobs, thanks to the ongoing boom in manufacturing and well-filled order books in construction. Trade and business services, which tend to offer largely part-time jobs, also hired additional staff.

Employment continues to rise, spurred by the buoyant economy; the decline in unemployment, on the other hand, decelerated in August.

The number of job vacancies registered with the Public Employment Service increased once more in August and at 42,000 exceeded the year-earlier figure by 14 percent.

The decline in unemployment is modest, when measured against the employment gains. In August, 191,200 persons were registered as unemployed with the Public Employment Service, a drop by 4.8 percent from a year earlier. Unemployment has been falling at a slower pace since the upturn began. The reduction of training measures since the beginning of the year (August –6,400 persons) has also slowed down the decline in unemployment.

The unemployment rate stood at 5.3 percent in August, 0.3 percentage point below the year-earlier rate, according to the Austrian method of calculation. According to Eurostat, it was 4.3 percent, seasonally adjusted. Long-term unemployment has also been falling – the number of persons out of work for longer than one year fell by 1,800 to 5,900 in August.